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SUPREME COURT OF THE UNITED STATES

OCTOBER 1947 TERM

No. 682

WARREN J. HARANG,
Petitioner,

versus

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

ARTHUR A. MORENO,
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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

Warren J. Harang prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fifth Circuit, entered in the above cause on the 30th day of December, 1947, reversing a judgment of the United States District Court for the Eastern District of Louisiana.

THE OPINION BELOW.

The Judge of the United States District Court wrote an opinion holding that the plaintiff was entitled to recover and setting out findings of fact and conclusions of law. (Tr. 75-82). *Harang v. United States*, 68 Fed. Supp. 227.

The opinion of the United States Circuit Court of Appeals is reported as "United States of America v. Warren J. Harang" (Record 87).

JURISDICTION.

The judgment of the United States Circuit Court of Appeals was entered on the 30th day of December, 1947 (Record 99). The jurisdiction of this court is invoked under Section 240 of the Judicial Code as amended by the Act of Feburary 13, 1925 (28 U. S. C. A. § 347).

THE QUESTION PRESENTED.

(1) The question presented is whether, under Section 22 (a) of the Revenue Acts of 1936, c. 690, 49 Stat. 1648, and 1938, c. 289, 52 Stat. 447 and Section 22 (a) of the Internal Revenue Code of 1934, income growing out of the ownership, or use of, or interest in, real estate in Louisiana, received as royalties from an oil and gas lease may be treated as a partial alienation of the real estate, instead of as income.

(2) The question presented is whether royalties from a mineral lease covering property in Louisiana can be treated as other than income, so as to destroy the uniformity of the application of the Internal Revenue laws of the United States, and more particularly the application of Section 22 (a) of the Internal Revenue Code of 1934, as amended.

(3) The question presented is whether this case, reaffirming the principle of *Commissioner of Internal Revenue v. Gray*, 159 Fed. (2d) 834 (Fifth Circuit), holding that royalty from a mineral lease is a consideration for the

partial alienation of real estate, is to prevail over the conflicting opinions of *Commissioner of Internal Revenue v. Fleming*, 82 Fed. (2d) 324 (Fifth Circuit); *Pettit v. Commissioner of Internal Revenue*, 118 Fed. (2d) 816, (Fifth Circuit); *Lee v. Commissioner of Internal Revenue*, 126 Fed. (2d) 825, (Fifth Circuit); *Sunray Oil Company v. Commissioner of Internal Revenue*, 147 Fed (2d) 962, (Tenth Circuit).

STATUTE INVOLVED.

Section 22 (a) of the Revenue Acts of 1936, c. 690, 49 Stat. 1648, and 1938, c. 289, 52 Stat. 447 and Section 22 (a) of the Internal Revenue Code.

STATEMENT.

For the purpose of trial, it was stipulated that the suit was brought under Section 24 of the Judicial Code, Paragraph 3 (28 U. S. C. 41 (20)), and was properly brought against the United States; that Warren J. Harang is a resident of Louisiana and paid tax deficiencies for the years 1942 and 1943 in the sum of $11,892.45, for which claims for refund were timely made and rejected; that the income upon which the deficiencies were claimed was for the receipt of royalties under a drilling contract for oil and gas; that the property subject to the lease was situated in Louisiana and was the separate property of Warren J. Harang; that the plaintiff was married under the system of the community of acquets and gains, and the income was returned as community income; that the Commissioner claimed that royalties from the separate property of the plaintiff was not community income, but the receipt of a

consideration for the partial alienation of real estate and assessed the deficiencies. (Record 43-46).

Article 2402 of the Revised Civil Code of Louisiana provides as follows:

> "*Art. 2402:* "This partnership or community consists of the *profits* of all the effects of which the husband has the administration and enjoyment, either of right or in fact, of the produce of the reciprocal industry and labor of both husband and wife, and of the estate which they may acquire during the marriage, either by donations made jointly to them both, or by purchase, or in any other similar way, even although the purchase be only in the name of one of the two and not of both, because in that case the period of time when the purchase is made is alone attended to, and not the person who made the purchase."

If the opinion in this case were to stand alone, it would appear that the decision rested upon only an interpretation and application of Louisiana law. The decision, however, is more far reaching than a decision of local law, because it involves a question of Federal income tax law. The decision is in conflict with decisions on the same question by other Circuit Courts of Appeals and in conflict with decisions in the Fifth Circuit Court. The judgment which this court is asked to review reaffirms the judgment in the case of *Commissioner of Internal Revenue v. Gray*, 159 Fed. (2d) 834. The Circuit Court of Appeals in this case said:

> "We find no error in the decision in the Gray case, and accordingly it is reaffirmed." (Record 97).

If the decision in the *Gray* case is correct, then certiorari should be denied in this case, but if the decision in the *Gray* case is incorrect, then certiorari should be granted to review the judgment and correct the error of the *Gray* case. It, therefore, becomes imperative that the decision of the *Gray* case, which is the foundation of this case, should be examined. In the *Gray* case, the Court of Appeals for the Fifth Circuit, under facts precisely similar to this case, *held that royalties were not income like rent for the use of property, but were a consideration for the partial alienation of the property.* In the *Gray* case, the court said: (842)

> "*As the execution by the fee owner of an oil and gas lease is a dismemberment of the property amounting to a partial alienation, and the bonus is the cash consideration paid therefor*, it follows that a bonus paid the taxpayer for an oil and gas lease fell into his separate property". (Italics ours).

The denial that royalties are income, as provided by the Internal Revenue Code and as provided by the law of Louisiana, (Act 21 of 1924, as amended; Sec. 8587.31 p. 229, Dart's General Statutes of Louisiana, Vol. 6), but are a consideration for the alienation of real estate, was the basis of deciding against the taxpayer. The decision complained against produced the anomaly that although royalties, under the Internal Revenue Code, are income and not profit, or a capital gain from the sale of property, yet the decision of the Circuit Court of Appeals produces the contradictory situation that royalties are a capital gain, but cannot be treated as a capital gain, but must be re-

turned as ordinary income. If these royalties are the consideration for the alienation of the real estate of the husband, they fall into his separate income, but if they are ordinary income from his separate property, they fall into the community. *Bender v. Pfaff*, 272 U. S. 127.

The fact that the court was dealing with royalties from the separate property of the husband, for the purpose of ascertaining their final destination, does not interdict the application of the principle that royalties are income from the use of property and not a consideration for a partial alienation. The final destination of these royalties, whether as separate income or community income, does not change their nature, under the decisions of Louisiana, as rent, nor, under the Internal Revenue Code, as income. If royalties are a consideration for the partial alienation of real estate, then these royalties, for every purpose and in every conceivable situation, must be a consideration for the sale of real estate. These royalties cannot be the consideration for the alienation of real estate in the case of a married man and income in the case of a single man. If royalties are a consideration for the sale of property, they must be so in every oil and gas contract, and if not income, then returnable as a capital gain. They cannot at one time be both.

Royalties under a contract with an unmarried man cannot be gross income, but royalties from a contract with a married man a consideration for the partial alienation of real estate. If that be so, then the nature of royalties as gross income would vary with the circumstance of whether the recipient is unmarried or is married. This concept of variation, dependent upon the marital status of

the recipient of the royalties, if permitted to exist, because of the *Gray* case and its reaffirmation in the Harang case, would destroy the uniformity of the taxing statutes, which the courts aim to preserve. If royalties are a consideration for a partial alienation of real estate, they are the purchase price of land and returnable as a capital gain. However, Congress has enacted otherwise. If the command of Congress be obeyed, they are income, and, if income from the separate property of the husband, they are community income and returnable as such. If they are not income, they may be returned as a capital gain. Congress and the Courts forbid such a return.

Under the law of Louisiana the profits from the separate estate of the husband fall into the community. *Glenn v. Elam*, 3 La. Ann. 611; *Cooper v. Cappel*, 20 La. Ann. 213, 215; *Denegre v. Denegre*, 30 La. Ann. 275, 276; *Smith v. Riddick*, 42 La. Ann. 1055; *Succession of Weber*, 49 La. Ann. 1494. The rental from the separate property of the husband is a profit from the property and is community income. *Barbin v. Couvillon*, 122 La. 407; *Succession of Goll*, 156 La. 910; *Peters v. Klein*, 161 La. 664, 667. It is the uniform jurisprudence of Louisiana that royalties are rent:

> "It is well settled that the paying of a royalty under a mineral lease, is the paying of rent. *Spence* v. *Lucas*, 138 La. 763, 70 So. 796; *Logan v. State Gravel Co.*, 158 La. 105, 103 So. 526; *Board of Commissioners of Caddo Levee District v. Pure Oil Co.*, 167 La. 801, 120 So. 373; *Roberson v. Pioneer Gas Co.*, 173 La. 313, 137 So. 46; 82 A. L. R. 1264. *Shell*

Petroleum Corp. v. Calcasieu Real Estate and Oil Co., et al., 185 La. 751, 170 So. 791".

"On several occasions this court has decided that the usual oil and gas lease, with a cash or royalty consideration, or both, such as presently before us, is a contract of letting and hiring within the meaning of the codal articles, and therefore does not create a servitude on the realty or a real right in the land. *Cooke v. Gulf Refining Co.*, 127 La. 592; 53 So. 874; *Rives v. Gulf Refining Co.*, 133 La. 178, 62 So. 623; *Cook v. Gulf Refining Co.*, 135 La. 609, 65 So. 758; *Gulf Refining Co. v. Hayne*, 138 La. 555, 70 So. 509, L. R. A. 1916D, 1147, Ann. Cas. 1917D, 130; *Spence v. Lucas*, 138 La. 763; 70 So. 796; *Hennen's Digest*, Vol. 1, 479, 480; *Allen v. Shreveport Mutual Bldg. Ass'n.*, 183 La. 521, 525, 164 So. 328; and articles 2669, 2670, 2671, 2674, 2679 of the Revised Civil Code". *Gulf Refining Co. of Louisiana v. Glassel, et al.*, 186 La. 190, 171 So. 846, 848.

"This court has also firmly established the rule that mineral leases would be construed as leases and the codal provisions applicable to ordinary leases would be applied thereto insofar as they may be". *Tyson v. Surf Oil Co.*, 195 La. 248, 196 So. 336, 342.

" 'Under the jurisprudence of this State "It is well settled that the payment of royalty, under a mineral lease, is the payment of rent' ". *Robinson v. Horton, et al.*, 197 La. 919, 2 So. (2d) 647, 649.

" 'The rule is well established that mineral leases *must* be construed as leases, and that the codal pro-

visions applicable to ordinary leases *must* be applied. *Tyson v. Surf Oil Co.*, 195 La. 248, 196 So. 336' ". *Coyle v. North American Oil Consolidated, et al.*, 201 La. 99, 9 So. (2d) 473, 478.

The Circuit Court of Appeals in this case did not discuss fully the applicable principles of Federal income statutes, but based its decision largely upon the ground that the Civil Code of 1808 used the word "fruits", and that the translators of the Code into English, in the Code of 1825, had substituted the word "profits". The Court then held that the word "fruits" was the proper word to be used in applying Article 2402 of the Revised Civil Code of 1870. The Court held that notwithstanding the Code of 1825 had constitutionally been enacted in English and not in French, nevertheless, the terms of the Civil Code of 1808 prevailed. The Court held that the controlling word in Article 2402, Revised Civil Code of 1870, was "fruits" and not "profits" as found in the Code of 1870, which is the latest. The Court overlooked the fact that whatever argument there might be as to whether the Code of 1825 was constitutionally enacted in English or in French that the Legislature by Act 68 of 1902 had re-enacted Article 2402 Revised Civil Code, as quoted above, and that the Legislature had used the word "profits" and not the word "fruits". The Circuit Court of Appeals did not discuss the unquestioned use of the word "profits" by the Legislature in 1902, so that regardless of what had occurred

before 1902 "profits" and not "fruits" is the determinative term regarding royalties from the separate property of the husband.

Whatever be the effect of the law of Louisiana, whether correctly or incorrectly interpreted by the Circuit Court of Appeals, is not material to a decision in this case. The question fundamentally is whether royalties are income or a consideration for the sale of property when tested by provisions of Federal income taxation. The unbroken line of jurisprudence of this Court is that royalties are income and returnable as income and not as a gain or loss from the sale of real estate. *McLean v. Commissioner of Internal Revenue*, 120 Fed. (2d) 942 (Fifth Circuit); *Staunton Industrial Loan Corporation v. Commissioner of Internal Revenue*, 120 Fed (2d) 930-935 (Fourth Circuit); *Burnet v. Harmel*, 287 U. S. 103; *Morgan v. Commissioner*, 309 U. S. 78-80; *Helvering v. Stuart*, 317 U. S. 154-162; *Anderson v. Helvering*, 310 U. S. 404-407; *Douglas v. Commissioner of Internal Revenue*, 322 U. S. 275-280.

CONCLUSION.

The decision in this case, based upon the decision in the *Gray* case, is in conflict with the holdings of other circuits on the question of the nature of royalties and is clearly and directly opposed to the principles enunciated by this Court in various and unvarying decisions. If royalties in oil and gas leases in Louisiana are not income, but are a consideration for the partial alienation of real estate, then, inevitably, these royalties are not to be returned as ordinary income, but may be returned as a capital gain.

Will the Commissioner of Internal Revenue permit a Louisiana taxpaper to return royalties as a consideration for the alienation, either partial or whole, of real estate on the basis of a capital gain and demand that taxpapers in other states return such royalties as gross income? Unless certiorari be granted and the principle of the *Gray* case and this case be abrogated, that must be the logical and legal result.

It is, therefore, respectfully submitted that for the reasons stated herein this petition for a writ of certiorari should be granted.

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March, 1948.

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ORIGINAL BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

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IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

May It Please the Court:

This case considered, if standing alone and unrelated to the decision of *Commissioner of Internal Revenue v. Gray*, 159 Fed. (2d) 834, would be merely an interpretation and application of the local law of Louisiana. Analyzed for its importance to the taxing statutes of the United States, it must appear that the case involves a Federal question and not a local question. While the opinion deals with a historical interpretation of Louisiana law, yet its substance is found in the reaffirmation of the principle of the *Gray* case. That case is contradictory of the deci-

sions of the Circuit Courts of Appeals of the circuits and is opposed to decisions in the Fifth Circuit.

Even if that were not so, the principle of the *Gray* case, reaffirmed in this case, is wholly destroyed by the decisions of this Court. If the decision of this case, based upon a decision of the *Gray* case, affected merely the destination of royalties as between the separate income of the husband, or the community existing between the husband and the wife, then it is conceivable that this Court would not grant certiorari. However, the need of reviewing the judgment of the Circuit Court of Appeals is imperative if the jurisprudence relating to the Federal income tax is to be kept in a straight current, and its uniformity preserved.

Under the law of Louisiana, the husband is the head and master of the community. As such, he has the absolute right of managing his own property and has the right to manage the separate property of the wife, unless she should assert her right of sole and uncontrolled management. The income from the separate property of the husband falls into the community and the income from the separate property of the wife likewise falls into the community, unless the wife retains the sole management of her own property. (Article 2402, Revised Civil Code, and Article 2386, Revised Civil Code).

It is unquestionable that under the law of Louisiana the word "fruits" has a different meaning from the word "profits". However, whatever be the difference in

meaning, Article 2402 of the Revised Civil Code, provides as follows:

> ART. 2402. *Property forming community—Personal injuries to wife.*—This partnership or community consists of the profits of all the effects of which the husband has the administration and enjoyment, either of right or in fact, of the produce of the reciprocal industry and labor of both husband and wife, and of the estate which they may acquire during the marriage, either by donations made jointly to them both, or by purchase, or in any other similar way, even although the purchase be only in the name of one of the two and not of both, because in that case the period of time when the purchase is made is alone attended to, and not the person who made the purchase.

Louisiana has adopted the fugacious theory of oil and gas. *Frost Johnson Lumber Co. v. Sallings' Heirs*, 150 La. 756. The surface owner does not own the oil and gas until reduced to possession. The owner of the land has only a right to drill for oil and gas and when reduced to possession becomes the owner. When the owner of the land contracts with another for the exercise of the right to drill for oil and gas, the consideration is usually denominated as royalties. "Mineral leases will be construed as leases and not sales". *Spence v. Lucas*, 138 La. 763. Rent is the consideration for such a contract, notwithstanding it may be termed "royalty". *Board of Commissioners of Caddo Levee District v. Pure Oil Company*, 167 La. 801, 811; *Roberson v. Pioneer Gas Company*, 173 La. 313, 319; *Shell Petroleum Corporation v. Calcasieu Real Estate Co.*,

185 La. 751, 771; *Glassell v. Gulf Refining Co.*, 186 La. 190. Rent from the separate property of the husband is community income. *Barbin v. Couvillon*, 122 La. 407; *Succession of Goll*, 156 La. 910; *Peters v. Klein*, 161 La. 664.

> " 'It is well settled that the paying of a royalty under a mineral lease, is the paying of rent. *Spence v. Lucas*, 138 La. 763, 70 So. 796; *Logan v. State Gravel Co.*, 158 La. 105, 103 So. 526; *Board of Commissioners of Caddo Levee District v. Pure Oil Co.*, 167 La. 801, 120 So. 373; *Roberson v. Pioneer Gas Co.*, 173 La. 313, 137 So. 46, 82 A. L. R. 1264.' " *Shell Petroleum Corp. v. Calcasieu Real Estate and Oil Co., et al.*, 185 La. 751, 170 So. 791.

The income tax law of Louisiana is substantially the same as the income tax statutes of the United States. (*Louisiana General Statutes, Dart*, Sec. 8587.31 p. 229). Rent from the separate property of the husband falls into the community.

Regardless of Louisiana law, it is clear that the statement in the *Gray* case, reaffirmed in this case, that royalty is the consideration for the partial alienation of land contravenes the unvaried jurisprudence of this Court that royalty is ordinary income and must be returned as such, and not as a capital gain from the sale of land. In the *Gray* case it is said:

> "As the execution by a fee owner of an oil and gas lease is a dismemberment of property amounting to a partial alienation and the bonus is the cash consideration paid, therefore, it follows that the bonus

paid the taxpayer for an oil and gas lease falls into his separate estate".

The statement implies that such a lease is a sale and that the consideration therefor is not income. We respectfully say that this statement is in direct conflict with *McLean v. Commissioner of Internal Revenue*, 120 Fed. (2d) 942 (Fifth Circuit). In that case, McLean transferred to the Yount-Lee Oil Company his interest in certain proved leases for a consideration of $500,000.00 cash and $2,000,000.00 to be paid out of 1/8 of the gross oil produced and saved from the leases. McLean treated the consideration as the price of a sale and not as income. The Commissioner disallowed the contention and held, regardless of the manner of payment, that the consideration received by him was income.

The court said:

> "Without undertaking any detailed or nice analysis of the language in the instrument upon which taxpayer relies we think it plain that the transaction as a whole comes strictly within the ruling in Palmer v. Bender and Burnet v. Harmel, Cf. Morrow v. Scofield, 5 Cir., 116 F. (2d) 17, and Pettit v. Commissioner, 5 Cir., 118 F. (2d) 816. Precisely as in Palmer v. Bender, the taxpayer here, in the instrument of transfer, reserved in himself an interest in the oil in place, and thereby and as a result thereof, secured for himself, 'income derived from the extraction of the oil to which he must look for a return of his capital'.

"Precisely as in Palmer's case, the taxpayer here retained a right to a share in the oil as produced and an economic interest in the oil in place which is depleted by production. Precisely as in that case, the taxpayer obtained as part consideration, for letting the sub-lessee in, a part of the fruits of the land as they might be produced, both as to the royalty and as to the payments in oil. Nothing either in the opinion in the Elbe case or in the application of its principles to its facts, affords taxpayer any comfort. The opinion re-affirms Palmer v. Bender and the result there was reached because there was no reservation of royalty, there was no retention of ownership of or interest in, the minerals in place. There was only a personal covenant to pay the taxpayer, not out of minerals in place, but out of the net proceeds of a processing or manufacturing operation".

Burnet v. Harmel, 287 U. S. 103, clearly controls this case, and, we respectfully say, demonstrates the clear conflict between the decision in the *Gray* case and in the cited case. In that case, Harmel owned land in Texas, where oil and gas in place is, under the Texas law, a part of the realty. He granted a lease "in return for bonus payments aggregating $57,000.00 in cash and stipulated royalties measured by the production of oil and gas by the lessee". He reported the $57,000.00 as gain from a sale of capital assets. The Commissioner treated the payments as ordinary income and assessed the tax at the higher rate. The court, following *Ferguson v. Commissioner*, 45 Fed. (2d) 573, held that because Texas law regarded an oil and

gas lease as a sale of the oil and gas in place, the $57,000.00 was taxable as a capital gain.

This Court granted certiorari and reversed. Regarding the contention that the bonus payment was to be treated as capital gain, the court said:

> "The payment of an initial bonus alters the character of the transaction no more than an unusually large rental for the first year alters the character of any other lease, and the taxation of one as ordinary income does not act as a deterrent upon conversion of capital assets, any more than the taxation of the other".

The *Gray* case treats the royalties received by the taxpayer as a consideration for the sale of a capital asset and seeks to differentiate it from ordinary rent by saying that the rent intended by the Louisiana law is rent for non-consuming property. This differentiation is disposed of by your Honors as follows:

> "It was argued that since the net result of the mining operation is a conversion of capital investment as upon a sale, the money received by the corporate owner or lessor, being its capital in a changed form, could not rightly be deemed to be income. But that argument was rejected, both with respect to the proceeds of mining operations carried on by the corporate owner on its land, *Stratton's Independence v. Howbert, supra; Goldfield Consolidated Mines Co. v. Scott*, 247 U. S. 126; see *Stanton v. Baltic Mining Co.*, 240 U. S. 103, 114, and with respect to payments made by the lessee to the corporate lessor un-

der the provisions of a mining lease. *Von Baumbach v. Sargent Land Co.*, 242 U. S. 503, 521, 522; *United States v. Biwabik Mining Co.*, 247 U. S. 116". *Burnet v. Harmel (Supra).*

The court then reviewed the history of congressional enactments and said that, with the juridical history before it, Congress intended that payment of royalties was income. It further said:

> "Here we are concerned only with the meaning and application of a statute enacted by Congress, in the exercise of its plenary power under the Constitution, to tax income. The exertion of that power is not subject to state control. It is the will of Congress which controls, and the expression of its will in legislation, in the absence of language evidencing a different purpose, is to be interpreted so as to give a uniform application to a nationwide scheme of taxation. See *Weiss v. Weiner*, 279 U. S. 333, 337; *Burk-Waggoner Oil Assn. v. Hopkins*, 269 U. S. 110; *United States v. Childs*, 266 U. S. 304, 309. State law may control only when the federal taxing act, by express language or necessary implication, makes its own operation dependent upon state law. See *Crooks v. Harrelson*, 282 U. S. 55; *Poe v. Seaborn*, 282 U. S. 101; *United States v. Loan & Building Co.*, 278 U. S. 55; *Tyler v. United States*, 281 U. S. 497; see *Von Baumbach v. Sargent Land Co., supra*, 519".

The court further said that the title to the oil and gas lease passes from the landowner when he conducts

mining operations on his own land, but as was pointed out in *Stratton's Independence v. Howbert*, since that

> "is only an incident to the use of his land for oil production, the operation, considered in its entirety, cannot be viewed as a sale or a conversion of capital assets. Like considerations govern here".

The court further said:

> "Bonus and royalties are both consideration for the lease and are income of the lessor".

In the final analysis, the fundus of the issue is not Louisiana law. The issue involves the uniform application of the laws of Congress. The incidence of congressional taxation falls on income and capital gains. Each is treated differently, but, at the threshhold of the inquiry, must be found the answer as to whether royalties represent income, or the proceeds of an alienation.

In the *Gray* case, it is said:

> "An oil and gas lease is a dismemberment of the property amounting to a partial alienation and bonus is the cash consideration paid therefor".

If, generically, a mineral lease is an alienation of the estate, the fact that it is partial does not destroy the genus. The command of Congress is that the Commissioner of Internal Revenue shall not consider royalties as the proceeds of an alienation, whether partial or whole, but shall consider these royalties as income. Whenever a taxpayer has claimed the right to return royalties on the basis of a sale of a capital asset, with the privilege of paying the

smaller tax, the attempt has been consistently resisted by the Commissioner. Will the Government in this case admit that a mineral lease is an alienation of the real estate, belonging to the taxpayer, whether partial or whole, and permit the taxpayer to return the royalties as a capital gain? Is there any case in which the Commissioner has conceded that a mineral lease is an alienation and royalties are capital gains and not income? If the Commissioner concedes that royalties are the purchase price received for the alienation of real estate, then, the Commissioner must concede that royalties are not to be treated as income, but as capital gains and taxed as such. Congress has enacted that royalties are income and nothing in the law of Louisiana, either by terminology, or by legislation, can destroy their nature. However, the concept of royalties as rent under the law of Louisiana, does not conflict with the congressional determination but, on the contrary, harmonizes with the congressional choice.

Sec. 22. Gross Income.

(a) *General Definition.*—"Gross income" includes gains, *profits*, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, *growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profit, and income derived from any source whatever.* * * * (26 U. S. C. 1940 ed., Sec. 22). (Italics ours).

The provisions of Section 22 (a) of the Revenue Acts of 1936, c. 690, 49 Stat. 1648, and 1938, c. 289, 52 Stat. 447, are identical with the quoted provisions of Section 22 (a) of the Internal Revenue Code.

The contract by which the royalties are created is a matter of Louisiana law, but when royalties are the result of the Louisiana contract, the power of Congress attaches and makes them income. "Once rights are obtained by local law, whatever they may be called, these rights are subject to the federal definition of taxability". *Helvering v. Stuart*, 317 U. S. 154, 162. State law creates legal interest and rights. The federal revenue acts designate what interests or rights, so created shall be taxed. *Morgan v. Commissioner*, 309 U. S. 78, 80.

> ". . . Furthermore, we are mindful that, wherever possible, federal taxing statutes are to be uniformly interpreted. Cf. *Burnet v. Harmel*, 1932, 287 U. S. 103, 110, 53 S. Ct. 74, 77 L. Ed. 199; *Thomas v. Perkins*, 1937, 301 U. S. 655, 659, 57 S. Ct. 911, 81 L. Ed. 1324; *Lyeth v. Hoey*, 1938, 305 U. S. 188, 194, 59 S. Ct. 155, 83 L. Ed. 119, 119 A. L. R. 410. Also, cf. *New York v. Feiring*, May 26, 1941, 61 S. Ct. 1028, 85 L. Ed.........; *Commissioner v. Greene*, 9 Cir., April 21, 1941, 119 F. (2d) 383. As Mr. Justice Stone recently stated in *United States v. Pelzer*, March 3, 1941, 61 S. Ct. 659, 661, 85 L. Ed. ......: 'But as we have often had occasion to point out the revenue laws are to be construed in the light of their general purpose to establish a nationwide scheme of taxation uniform in its application. Hence their provisions are not to be taken as subject to state con-

trol or limitation unless the language or necessary implication of the section involved makes its application dependent on state law.'" *Staunton Industrial Loan Corporation v. Commissioner of Internal Revenue*, 120 F. (2d) 930, 935.

The issue here is not one of state law, but of Congressional enactment. Whatever views based on comparison and analogies courts might have otherwise adopted if Congress had not acted, "*Congress, has recognized the peculiar character of the business of extracting natural resources. Leases are a method of exploitation of the land for oil and payments under leases are 'income to the lessor' like payments of rent*". *Burton-Sutton Oil Co. v. Commissioner*, 328 U. S. 25. (Certiorari to Fifth Circuit).

Since Congress has said that what the petitioner received was income, and not the consideration of an alienation, either partial or otherwise, that income should be treated like any other income. Congress has made no distinction between forms or sources of income. Since the right has been recognized of spouses living under the community system to treat as community income the income received as rent for the letting of a house, or a building there is no reason to treat these royalties otherwise than as community income, since royalties are rent. (*Burton-Sutton Oil Co. v. Commissioner*, supra). It would be a fantastic system of laws if Congress could treat royalties as rent and, therefore, income for the purpose of taxation, and yet, when it comes to its return as income by the community, to treat it differently from other income. Until Congress has declared that royalties, considered as in-

come, shall be treated differently from all other income, it follows logically that like every other species of income, it is subject to the local law as to ownership. Since the right, under local law, to return rent from the separate property of the husband as community income has been recognized, the Commissioner must find some basis for differentiating the income, received as royalties, from the income received as rent for a building, in order to treat royalties differently from every other species of rent.

> ". . . Royalty or bonus payments in advance of actual extraction of minerals are, like sales after severance of royalty payments on actual production, gross income and not a recovery of capital. *Stratton's Independence v. Howbert*, 231 U. S. 399, 418; *Stanton v. Baltic Mining Co.*, 240 U. S. 103, 114; *Burnet v. Harmel*, 287 U. S. 103; *Herring v. Commissioner*, 293 U. S. 322, 324. Cf. *Anderson v. Helvering*, 310 U. S. 404, 407, 407-8." *Douglas v. Commissioner of Internal Revenue*, 322 U. S. 275, 280.
>
> "Oil and gas reserves like other minerals in place, are recognized as wasting assets. The production of oil and gas, like the mining of ore, is treated as an income-producing operation, not as a conversion of capital investment as upon a sale, and is said to resemble a manufacturing business carried on by the use of the soil. *Burnet v. Harmel*, 287 U. S. 103, 106-107; *Bankers Coal Co. v. Burnet*, 287 U. S. 308; *United States v. Biwabik Mining Co.*, 247 U. S. 116; *Von Baumbach v. Sargent Land Co.*, 242 U. S. 503, 521, 522; *Stratton's Independence v. Howbert*, 231 U. S. 399, 414. The depletion effected by pro-

duction is likened to the depreciation of machinery or the using up of raw materials in manufacturing. *United States v. Ludey*, 274 U. S. 295, 302, 303; *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364, 370." *Anderson v. Helvering, Commissioner of Internal Revenue*, 310 U. S. 404, 407-408.

"We need not decide whether technical title to the oil while in the ground was in assignors, or in assignee. The federal income tax Act is to be given a uniform construction of nation-wide application except insofar as Congress has made it dependent on state law." *Thomas, Collector v. Perkins, et al.*, 301 U. S. 655, 659.

"The state law creates legal interests, but the federal statute determines when and how they shall be taxed. We examine the Texas law only for the purpose of ascertaining whether the leases conform to the standard which the taxing statute prescribes for giving the favored treatment to capital gains. Thus tested, we find in the Texas leases no differences from those leases where the title to the oil and gas passes only on severance by the lessee, which are of sufficient consequence to call for any different application of section 208 (26 U. S. C. A. Int. Rev. Acts, page 13). The fact that title to the oil and gas is said to pass before severance rather than after, is not such a difference. The economic consequences to the lessor of the two types of lease are the same." *Burnet v. Harmel*, 287 U. S. 103, 53 S. Ct. 77.

* * * * * * * *

"Moreover, the statute speaks of a 'sale', and these leases would not generally be described as a 'sale' of the mineral content of the soil, using the term either in its technical sense or as it is commonly understood. Nor would the payments made by lessee to lessor generally be denominated the purchase price of the oil and gas. By virtue of the lease, the lessee acquires the privilege of exploiting the land for the production of oil and gas for a prescribed period; he may explore, drill, and produce oil and gas if found. Such operations with respect to a mine have been said to resemble a manufacturing business carried on by the use of soil, to which the passing of title of the minerals is but an incident, rather than a sale of the land or of any interest in it or in its mineral content. *Stratton's Independence v. Howbert*, 231 U. S. 399, 414, 415; see *Von Baumbach v. Sargent Land Co.*, 242 U. S. 503, 521."

". . . The very idea of the income tax from a constitutional viewpoint implies a differentiation between that which is capital and that which is the product or yield of capital. Nevertheless, the Supreme Court has definitely set this controversial point at rest. Since the decision of the Supreme Court in *Stratton's Independence v. Howbert*, 231 U. S. 399, 418, 34 S. Ct. 136, 58 L. Ed. 285, it has been settled that income derived from the sale of products from a mine or oil well is gross income from the operation of a business and not a recovery of capital."

. . .

"In *Anderson v. Helvering*, 310 U. S. 404, 407, 408, 60 S. Ct. 952, 954, 84 L. Ed. 1277, the court said: 'The production of oil and gas, like the mining of ore, is treated as an income-producing operation, not as a conversion of capital investment as upon a sale, and is said to resemble a manufacturing business carried on by the use of the soil. *Burnet v. Harmel*, 287 U. S. 103, 106, 107, 53 S. Ct. 74, 75, 77 L. Ed. 199; *Bankers Coal Co. v. Burnet*, 287 U. S. 308, 53 S. Ct. 150, 77 L. Ed. 325; *United States v. Biwabik Mining Co.*, 247 U. S. 116, 38 S. Ct. 462, 62 L. Ed. 1017; *Von Baumbach v. Sargent Land Co.*, 242 U. S. 503, 521, 522, 37 S. Ct. 201, 206, 61 L. Ed. 460; *Stratton's Independence v. Howbert*, 231 U. S. 399, 414, 34 S. Ct. 136, 139, 58 La. Ed. 285. The depletion effected by production is likened to the depreciation of machinery or the using up of raw materials in manufacturing. *United States v. Ludey*, 274 U. S. 295, 302, 303, 47 S. Ct. 608, 610, 611, 71 L. Ed. 1054; *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364, 370, 45 S. Ct. 274, 275, 69 L. Ed. 660. Compare *Von Baumbach v. Sargent Land Co., supra*, 242, U. S. at pages 524, 525, 37 S. Ct. 201, 208, 209, 61 L. Ed. 460.'" *Sunray Oil Co. v. Commissioner of Internal Revenue*, 147 Fed. (2d) 962, 965, 966, (C. C. A. 10th).

"(1) 1. The assignment and transfer of a producing oil and gas lease for cash and a reservation of an overriding royalty in some states, is the sale of the oil and gas in place, and in others, a sublease. The assignment, therefore, in the present case

would be a sale in some states and a sublease in others, dependent upon local law. In applying the income tax statute, however, the Supreme Court has held that technical distinctions of local laws will be disregarded, and the statute will be interpreted so as to apply uniformily." *Hogan v. Commissioner of Internal Revenue*, 141 Fed. (2d) 92, 94, (C. C. A. 5th).

". . . The production of oil and gas is an income producing operation, not a conversion of capital investment. *Anderson v. Helvering*, 310 U. S. 404, 60 S. Ct. 952, 84 L. Ed. 1277; *Pettit v. Com'r*, 5 Cir., 118 F. (2d) 816; *Columbia Oil & Gas v. Com'r*, 5 Cir., 118 F. (2d) 459; *Com'r v. O'Shaughnessy, Inc.*, 10 Cir., 124 F. (2d) 33.

"It being the accepted view now that the receipts of oil payments are the result of an income producing operation, and not of one which merely returns capital, it follows that the theory on which the Laird case was rested, that the receipts of oil payments were returns, not of income but of capital, has fallen and that the case must be regarded as overruled." *Lee v. Commissioner of Internal Revenue*, 126 Fed. (2d) 825, 826, (C. C. A. 5th).

"Burnet v. Harmel, 287 U. S. 103, 53 S. Ct. 74, 77 L. Ed. 199, on which appellant relies does not support him but is quite to the contrary effect. For, it makes clear that federal taxing statutes must be construed and given effect in the light of the taxing purpose they evidence and they will not be wrested out of the ordinary meaning their words

convey, to conform them to particular state legal concepts. There the court, declaring that a mineral lease with payment of a bonus was not a sale within the capital gains statute; that the bonus was merely an advance payment of royalties and subject to depletion allowance as royalty payments are; and pointing out that the capital gains statute was designed to overcome the evil of paying taxes in a lump in one year on gains accumulated over many years from the sale outright of assets in that year, held that it would be a perversion of the statute to construe it as applicable to a mineral lease, since returns come from it annually and not in a lump, and depletion is allowed on account of these returns, including the bonus.

"What was there said about state laws not being controlling upon the incidence of federal taxes was most appropriately said. The same thing was in effect said in Palmer v. Bender, 287 U. S. 551, 53 S. Ct. 225, 77 L. Ed. 489. There, a lessee of oil lands had transferred bonus and it was held that he had retained an economic interest which was depletable, without regard to the precise legal effect attributed under the state law to the instrument by which the transfer was effected." *Morrow v. Scofield*, 116 Fed. (2d) 17, 19, (C. C. A. 5th).

"Now in Texas, oil and gas in the ground are capable of ownership and sale separate from the soil which contains them, and leases such as are here involved convey to the lessee title to the oil and gas except such interests as are reserved to the lessor.

In Louisiana and many other states this is not true, but the lease only gives the lessee the right to use the land to capture the oil and gas which belong fully to no one until reduced to possession. Neverless, in order to give the federal income tax laws a uniform operation throughout the United States, these local differences are ignored in dealing with income and deductions; and an oil and gas lease is from the standpoint at least of the land-owner regarded as only a means of producing oil and gas from his land, and what he gets from it, whether in money or in oil or the proceeds of oil as produced, is income from the use of his land. Even when a lump sum is paid down by a lessee as a bonus in addition to a retained royalty, the bonus is considered as being an advance on royalties and to be income and not purchase money." *Commissioner of Intional Revenue v. Fleming*, 82 F. (2d) 324, 326, (C. C. A. 5th).

"(1) The income received by the lessor from an oil and gas lease, whether by way of an initial bonus or as royalties on the oil and gas subsequently produced by the lease, is taxable not as gain from the 'sale' or capital assets, but as ordinary income. *Burnet v. Harmel*, 287 U. S. 103, 53 S. Ct. 74, 77 L. Ed. 199; *Murphy Oil Co. v. Burnet*, 287 U. S. 299, 53 S. Ct. 161, 77 L. Ed. 318; *Bankers' Pocahontas Coal Co. v. Burnet*, 287 U. S. 308, 53 S. Ct. 150, 77 L. Ed. 325; *Strother v. Burnet*, 287 U. S. 314, 53 S. Ct. 152, 77 L. Ed. 330; *Comar Oil Co. v. Burnet*, 64 F. (2d) 965; (C. C. A. 8); *Pitman v. Commis-

sioner, 64 F. (2d) 740 (C. C. A. 10); *Commissioner v. Jamison Coal & Coke Co.*, 67 F. (2d) 342 (C. C. A. 3)." *Umsted, et al., v. Commissioner of Internal Revenue*, 72 Fed. (2d) 328-329, (C. C. A. 8th).

". . . Such leases did not convey title to the oil and gas in place. They only gave the lessee the right to go upon the land and to prospect for, develop, and remove oil and gas therefrom. Under them the respective lessees would acquire title only to the oil and gas which they extracted and reduced to possession. *Hover v. McNeill*, 102 Kan. 492, 175 P. 150; *Finch v. Beyer*, 94 Kan. 525, 146 P. 1141; *Priddy v. Thompson* (C. C. A. 8) 204 F. 955; *Alexander v. King*, (C. C. A. 10) 46 F. (2d) 235, 238, 239, 74 A. L. R. 174. The bonuses were therefore in the nature of advanced royalties and were income from the land. *Burkett v. Commissioner*, (C. C. A. 8) 31 F. (2d) 667; *Berg v. Commissioner*, 59 App. D. C. 86, 33 F. (2d) 641; *Work v. Mosier*, 261 U. S. 352, 357, 43 S. Ct. 389, 67 L. Ed. 693; *Alexander v. King*, (C. C. A. 10) 46 F. (2d) 235, 239, 74 A. L. R. 174." *Ferguson v. Commissioner of Internal Revenue*, 59 Fed. (2d) 891, 892, (C. C. A. 10th).

Profits are income for purposes of internal revenue. Under Article 2402 of the Revised Civil Code, the profits from the separate estate of the husband fall into the community. There can be no doubt, from a consideration of income tax statutes, regulations and laws, that royalties are among the profits subject to taxation. *Section #114 "Basis for Depreciation and Depletion-"* clearly shows the purpose of Congress that royalties shall be considered as

income, subject to a rate of depreciation that would theoretically restore to the owner of the land its capital value. Since Congress has enacted that royalties are income, it lies within the power of no state to nullify the congressional purpose by providing that royalties are not income but a return of capital. The interdiction of such a power in any state has been pronounced by Your Honors in numerous cases.

It would seem true, with the inflexibility of mathematics, that royalties on oil producing land in Louisiana are rent and so fall within the definition of gross income as defined by Congress. The exertion of the constitutional power of Congress over income taxation gives it the right to define what shall be income. The exercise of that power is not subject to state control. It is not within the power of the State of Louisiana to say what Congress has defined as income is not income. The power of the state to define royalties is controlled by the paramount power of Congress, and Congress having declared that royalties are income the state is without right to say that they are not income. If they be income, subject to taxation by the Federal Government, then, they must be income for every purpose connected with income taxation under the laws of Congress. They cannot be income for purposes of levying a tax and not income in connection with their destination when measuring the tax.

A lengthy brief has expounded a long argument which could have been compressed in a contention tersely stated. The argument is susceptible of being reduced to the simplicity of syllogistic reasoning to reach the juri-

dical conclusion. Congress has defined gross income as including "profits" or "growing out of the ownership of property" and the controlling jurisprudence holds that royalties grow out of the ownership of land. Article 2402 of the Revised Civil Code provides that community income consists "of the profits" of the separate property of the husband and jurisprudence has recognized the right of a Louisiana husband and wife to make community returns, including rents from the separate property of the husband as community income. Therefore, since Congress taxes income from the ownership of land and Louisiana jurisprudence recognizes as community income the consideration for the use of the property of the husband, Warren J. Harang had the right to return his royalties, defined by federal and Louisiana jurisprudence as rent and as community income.

Respectfully submitted,

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CASES:

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1947

No. 682

WARREN J. HARANG,
Petitioner

versus

UNITED STATES OF AMERICA

On Petition for a Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

REPLY BRIEF ON BEHALF OF PETITIONER.

May It Please the Court:

In the brief of the Government opposing the granting of a writ of certiorari, the startling statement is made that the United States Circuit Court of Appeals decided only a question of Louisiana law, and, therefore, no federal question was involved. It is said by Government counsel:

> "To the extent that the petition for a writ of certiorari (Pet. 4-10; Br. 4-22) has been framed

> on the assumption that there is a fundamental conflict between the decision below and the cases which uniformly hold that oil royalties are taxable as ordinary income rather than as proceeds from the sale of a capital asset (*Burnet v. Harmel*, 287 U.S. 103), the contention is without foundation".

The petition for a writ of certiorari was not framed to erroneously present a conflict of decision between the decision in *Commissioner vs. Gray*, 159 Fed. (2) 834 and the case at bar and other cases dealing with royalties but the issue framed itself. It is inescapable that the Court of Appeals was dealing with a question of income under the congressional statutes. The ultimate question decided was not as to where the income came to rest, but what was the nature of the income. It was necessary to decide whether royalties were ordinary income to determine whether the Commissioner was right in assessing the deficiency. Congress has in unqualified terms said that royalties, like rents, are ordinary income. The Court of Appeals, in defiance of the congressional command, has said that royalties are not ordinary income, but that royalties are the price paid to the taxpayer for the alienation of real estate. That was the ultimate issue in the case, and while the Court of Appeals discussed at great length the difference between "fruits" and "profits" to determine where the royalties finally came to rest, it nevertheless said unequivocally that royalties are not ordinary income as declared by Congress, but that royalties are the price for the partial alienation of land. It held that only the "fruits" of the separate estate of the husband fell into the community and royalties are not fruits. To determine whether or not these royalties fell into the community, or fell into the separate estate of the husband, the Court of Appeals was called upon to determine the nature of these royal-

ties, and, contrary to the congressional choice, said that these royalties were not income within the federal taxing statutes, but were the purchase price for the sale of land belonging to the husband, and, consequently, being the consideration for the partial alienation of his separate estate belonged to his separate estate, and did not belong to the community.

In the *Gray* case, the Commissioner contended that under the law of Louisiana royalties were not income like rent, and, consequently, not being income from the separate estate of the husband, did not fall into the community. The contention made in the *Gray* case was that royalties, unlike rents, were the consideration for the alienation of the separate property of Gray, and, being a consideration for the sale of his property, were not income, and, consequently, belonged to him and not to the community. This contention was rejected by the Tax Court, but upheld by the Court of Appeals, with the resulting anomaly that the Commissioner treated these royalties as a consideration for the sale of property, but yet compelled the taxpayer to pay a tax as if these royalties were ordinary income. The inconsistency of his position is that for the purpose of levying the tax, the royalties were ordinary income, but for the purpose of determining by whom the tax was to be paid, these royalties were the purchase price of land.

The involved reasoning of the Court of Appeals regarding "fruits" and "profits" is not greatly material here, but the historical background might be interesting. In 1811, Congress passed a statute admitting Louisiana to the Union. A condition of the admission was that the laws of Louisiana, theretofore passed in French, should be enacted in English. A Constitutional Convention was

held in 1811 and in 1812, the Constitution was adopted which, by Article 6, § 16 provided that the laws should be passed in English. Because of the large number of French speaking people, the code adopted in 1825 was adopted in English, but promulgated in both English and French. The English publication said that all of the "profits" from the separate property of the husband should fall into the community. (Article 2402 R. C. C.) The French version said that the "fruits" of the separate property of the husband shall fall into the community. The Louisiana Legal Archives, a compendium of the Codes of Louisiana, has a note that the word "fruits" in Article 2371 of the Code of 1825, which corresponds to the present Article 2402 of the Revised Civil Code, had been erroneously translated and that "fruits" had been translated into "profits". Although the revision of the Code of 1870 was enacted and promulgated in English, the Court of Appeals adopted the note in the Louisiana Legal Archives and held that only the "fruits" of the separate property of the husband fell into the community, and that royalties were not fruits within the meaning of the law.

This statement was made in spite of the fact that this court, in *Viterbo vs. Friedlander*, 120 U.S. 723, had distinctly held that the English Code of 1825 was the law, and not the French promulgation. The Court of Appeals further overlooked the compelling argument that regardless of what had gone before, that in 1902, Article 2402 of the Code had been amended by Act 68 of the General Assembly of 1902, and that the word "profits", and not the word "fruits" had been the chosen term. The Court then proceeded to hold that royalties were not fruits as contemplated by other parts of the Civil Code and that, consequently, royalties were not

income, but were a consideration for the partial alienation of the separate property of the husband.

The Court then affirmed the decision of *Commissioner vs. Gray, supra,* wherein the court said:

> "As the execution by a fee owner of an oil and gas lease is a dismemberment of property amounting to a partial alienation and the bonus is the cash consideration paid, therefore, it follows that the bonus paid the taxpayer for an oil and gas lease falls into his separate estate".

If this is not a decision contrary to the jurisprudence of this court and of the various federal courts, then, no federal court has ever decided a federal question. Congress has said that royalties, like rents, are ordinary income. The Court of Appeals in this case, by affirming the *Gray* case, has said that royalties are not income, but a cash consideration for the partial alienation of property. Based upon the declaration that royalties are not ordinary income, but a cash consideration for the partial alienation of property, the court held that the royalties belonged to the separate estate of the husband and did not fall into the community, like rent and other income to be returned as community income. *Poe vs. Seaborn,* 282 U.S. 101. It is true that the court did examine the Louisiana law to see to whom, under local law, these royalties belonged, but it is equally true that the court held they belonged to the husband and not to the community, because they were not ordinary income, but the sale of an asset. This conclusion is inevitable and contradictory of the decisions of this Court and other decisions on the subject.

It passes understanding, therefore, how it can be contended that the decision was based upon, and dealt only, with local law. At the foundation of the decision,

lies the repudiation of the declaration of Congress that royalties are ordinary income. If the court had held that these royalties were ordinary income, under Louisiana law, it would have been bound to hold that this was income belonging to the community. *Succession of Weber*, 49 La. Ann. 1494; *Barbin vs. Couvillon*, 122 La. 407; *Succession of Goll*, 156 La. 910; *Peters vs. Klein*, 161 La. 664.

Based upon the denial that royalties are ordinary income, the Court of Appeals upheld the Commissioner by holding that royalties are the price for the partial alienation of land. We can readily agree with that part of the brief in opposition which says:

> "While the federal taxing statute, in some instances, looks to local law to determine the owner of the income to whom it is to be taxed (*Poe v. Seaborn*, 282 U.S. 101; *Bender v. Pfaff*, 282 U.S. 127), the character of the income as being capital gain or ordinary income is a matter to be resolved solely under the criteria of the federal taxing statute which was intended to have a uniform application throughout the country (*Burnet v. Harmel, supra;* cf. *Palmer v. Bender*, 287 U.S. 551)".

There can be no doubt that this is a clear statement of the controlling principles, but, equally, there can be no doubt that the decision of the Court of Appeal is contrary to the stated principle.

We can partly agree and partly disagree with the statement of the brief in opposition to the following effect:

> "Similarly, the fact that oil royalties are taxed as ordinary income under the federal statute cannot, contrary to the taxpayer's underlying assumptions (Pet. 4-10; Br. 4-22), require

the State of Louisiana to regard them in a similar manner so as to make them fall into the community, nor change the law of that State which views them as proceeds from the sale of property and as belonging to the spouse from whose property they are derived".

There can be no doubt that the taxing statutes of the United States cannot condition the marital relations of Louisiana citizens. However, the court was not dealing with those marital relations, but was dealing with the taxing statutes of the United States, and those taxing statutes are to be viewed in accordance with federal jurisprudence. Federal jurisprudence declares that royalties are income and under the cited case of *Bender vs. Pfaff, supra,* coming up from Louisiana, this court held that the income of the husband and wife could be returned as community income. Since Congress has declared royalties to be income, and not the consideration from the sale of property, it must follow that it is income for every purpose of the taxing statutes. The statement that the law of Louisiana does not regard royalties as income, like rents, but as the cash consideration for the sale of property, finds no support in the law of Louisiana.

In *Spence v. Lucas*, 138 La. 763, the court said:

> "Interveners are not asking for more than the recognition of their lease. They are not claiming that the oil and gas under the surface of the soil was sold to them. They adopt the expression of opinion by the court in the cases of *Cooke v. Gulf Refining Co.*, 127 La. 592, 53 South. 874, *Rives v. Gulf Refining* Co., 133 La. 178, 62 South. 623, and *Cooke v. Gulf Refining Co.*, 135 La. 609, 65 South. 758, to the effect that mineral leases will be construed as leases, and not sales, and that the law with reference to leases will be applied thereto in so far as they may be".

In *Board of Commissioners of Caddo Levee District v. Pure Oil Company*, 167 La. 801, 811, the court said:

> "The next question to be considered is whether the prescription pleaded, which is a prescription relating to arrearages of rent, is applicable to this case. In the case of *Logan v. State Gravel Co.*, 158 La. 105, 103 So. 526, which involved a mineral lease, as does the present case, this court said:
>
> > " 'Our conclusion is that a mine or quarry, or land adapted to mining or quarrying, may be leased for a certain portion of the produce of such mine or quarry, and the fact that said portion is called 'royalty' instead of rent, is not of the least consequence. For rent (by whatever name called) is a certain profit in money, provisions, chattels, or labor, issuing out of lands and tenements in retribution for the use' ". (Citing) *King v. Harper*, 33 La. Ann. 496, citing Bouv. Law Dict. verbo, 'Rent' ".
>
> "In that case, the court recognized a lessor's privilege for the unpaid royalty or rent, thus giving the lease the effect of an ordinary lease. It is true that the royalty or rent charge involved in that case was an amount in money, based on the quantity of gravel removed from the land, whereas in this case the royalty or rent charge under the lease is one-eighth of the oil produced. That difference, however, is of no consequence, nor is the ruling in the case cited based on any such distinction. The rent charge 'may consist in a certain quantity of commodities, or even in a portion of the fruits yielded by the thing leased'. C.C. art. 2671".

In *Roberson v. Pioneer Gas Co.*, 173 La. 313, 319, the court said:

> "in oil and gas leases, under the settled jurispru-

dence of this state, the payment of a royalty is the payment of rent, and is not the payment of a price for the oil or gas rights, as if they were sold. See *Spence v. Lucas*, 138 La. 763, 70 So. 796; *Logan v. State Gravel Co.*, 158 La. 105, 103 So. 526; *Board of Commissioners of Caddo Levee District v. Pure Oil Co.*, 167 La. 801, 120 So. 373".

In *Shell Petroleum Corp. v. Calcasieu Real Estate & O. Co.*, 185 La. 751, 771, the Court said:

> "It is well settled that the paying of a royalty, under a mineral lease, is the paying of rent. *Spence v. Lucas*, 138 La. 763, 70 So. 796: *Logan v. State Gravel Co.*, 158 La. 105, 103 So. 526; *Board of Commissioners of Caddo Levee District v. Pure Oil Co.*, 167 La. 801, 120 So. 272; *Roberson v. Pioneer Gas Co.*, 173 La. 313, 137 So. 46, 82 A. L. R. 1264."

In *Gulf Refining Company vs. Glassell*, 186 La. 190, the court said:

> "On several occasions this court has decided that the usual oil and gas lease with a cash or royalty consideration, or both, such as presently before us, is a contract of letting and hiring within the meaning of the codal articles, and therefore does not create a servitude on the realty or a real right in the land. *Cooke v. Gulf Refining Co.*, 127 La. 592, 53 So. 874; *Rives v. Gulf Refining Co.*, 133 La. 178, 62 So. 623; *Cooke v. Gulf Refining Co.*, 135 La. 609, 65 So. 758; *Gulf Refining Co. v. Hayne*, 138 La. 555, 70 So. 509, L.R.A. 1916 D. 1147, Ann. Cas. 1917D, 130; *Spence v. Lucas*, 138 La. 763, 70 So. 796; Hennen's Digest, vol 1, 479, 480; *Allen v. Shreveport Mutual Bldg. Ass'n*, 183 La. 521, 625, 164 So. 328; and articles 2669, 2670, 2671, 2674, 2670 of the Revised Civil Code".

* * * * *

"Now it is said that a lease upon land for the drilling for oil and gas, fugitive minerals, is so basically different from a lease on realty for raising crops that the two kinds of leases should not be legally treated the same. Are they so different? They are granted by the owner in connection with his land for a consideration consisting of cash or part of the production therefrom, or both. The oil and gas lessee gets the products from under the surface of the ground and the lessee of a farm or plantation harvests the crops from the surface of the earth. They both get title to the products. Neither claims ownership of the land, and each is entitled to the use and enjoyment of the property for the purposes for which it was leased. In fact, it is easier to see greater similarity between an oil and gas lease and the lease of a farm than the lease of a building and a farm lease. Yet the latter are classified the same. It therefore appears to us that an oil and gas lease and farm lease are quite alike and should be placed in the same legal catefory, i. e., leases—personal rights and not real rights."

" * * * *Roberson v. Pioneer Gas Co.*, 173 La., 313, 137 So. 46, 82 A. L. R. 1264, held, as stated in the syllabus:

> " 'In oil and gas lease, payment of royalty is payment of rent, and not payment of price for oil or gas rights.
>
> " 'Lease, under civil law, does not convey to lessee temporarily title to property leased, but conveys only right to use or enjoyment of property. (Rev. Civ. Code, arts. 2669, 2674.)'

Tyson v. Surf Oil Co., 195 La. 248, 196 So. 336, 342.

"This court has also firmly established the rule that mineral leases would be construed as leases and the codal provisions applicable to or-

dinary lease would be applied thereto insofar as they may be."

Robinson v. Horton, et al., 197 La. 919, 2 So. (2d) 647, 649.

> " 'Under the jurisprudence of this State "It is well settled that the payment of royalty, under a mineral lease, is the payment of rent" ' ".

Coyle v. North American Oil Consolidated, et al., 201 La. 99, 9 So. (2d) 473, 478.

> " 'The rule is well established that mineral leases *must* be construed as leases, and that the codal provisions applicable to ordinary lease *must* be applied. *Tyson v. Surf Oil Co.* 195 La. 248, 196 So. 336' ".

The statement that the law of Louisiana views royalties "as proceeds from the sale of property and as belonging to the spouse from whose property they are derived", is clearly refuted by the cited cases. The citation of *Turbeville vs. Commissioner*, 84 Fed. (2d) 302, is wholly inapplicable to the decision of this case. The *Turbeville* case came up from Texas, where oil in place is regarded as a part of the realty and, consequently, a royalty contract was, under Texas law, regarded as the sale of real estate. Under the law of Louisiana, oil in place is not regarded as a part of the realty. The Louisiana court, in the often cited case of *Frost-Johnson Lumber Company v. Salling's Heirs*, 150 La. 756, held that oil in place was not a part of the realty. It adopted the fugacious theory of oil and gas and held that the surface owner did not own the oil and gas, but had merely the right of use of the land to explore for oil and gas, and when reduced to possession, to become the owner of such oil and gas. The holding of the Court of Appeals

that this was a dismemberment of the property and not a consideration for its use, is wholly at variance with the jurisprudence of Louisiana.

CONCLUSION

We respectfully say that the decision holding that royalties are the receipt of a consideration for the alienation of land is at variance with the decisions of this court and the decisions of other Courts of Appeal, and even with decisions in the 5th Circuit Court of Appeals, and unless that decision is set aside, Warren J. Harang will claim the right to return these royalties as a capital gain. Doubtless this will be resisted by the Commissioner and the case will come before this court again, because, certainly, royalties, insofar as Warren J. Harang is concerned, cannot be a capital gain in one year and ordinary income in another year. The question of the marital status of Warran J. Harang is no consideration for decision here. It would be an anomaly in the taxing laws of this country if it could be held that royalties, insofar as a married man is concerned, are not ordinary income, but as to a single man, they are ordinary income. The nature of royalties as ordinary income or capital gain cannot vary with the marital status of the landowner. The fall of the income as to whether within or without the community, cannot affect the nature of royalties. The difference in marital status cannot condition the category into which these royalties fall. Your Honors must pronounce as to whether royalties received in Louisiana are the cash consideration for the partial alienation of land, but in other states are ordinary income as proclaimed by Congress. Their nature is not varied by state lines.

The writ of certiorari should, therefore, be granted

upon the twin considerations that the Court of Appeals has failed to apply both the taxing statutes of Congress and the laws of Louisiana regarding the ownership of income.

Respectfully submitted,

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Of Counsel.

INDEX

CITATIONS

784119—48

In the Supreme Court of the United States

October Term, 1947

No. 682

Warren J. Harang, petitioner

v.

United States of America

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court, its findings of fact and conclusions of law (R. 75–82) are reported at 68 F. Supp. 227. The opinion of the Circuit Court of Appeals (R. 86–95) is reported at 165 F. 2d 106.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on December 30, 1947 (R. 95), and a petition for rehearing was denied on February 11, 1948 (R. 101). The petition for a writ of certiorari was filed on March 19, 1948. The juris-

diction of this Court rests on Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the Circuit Court of Appeals erred in holding that under Louisiana law oil royalties from the husband's separate property remain separate property and are taxable as his income under Section 22 (a) of the applicable Revenue Acts and of the Internal Revenue Code.

STATUTES INVOLVED

The applicable provisions of the statutes involved are set forth in the Appendix, *infra*, pp. 7–11.

STATEMENT

The facts in this case were stipulated by the parties (R. 43–74) and were found by the District Court in conformity with the stipulation (R. 76–77). The pertinent facts may be summarized as follows:

The taxpayer resides in Louisiana and, during the tax years involved, was married. There existed between the taxpayer and his wife a community of acquets and gains. The taxpayer owned, as his separate property, an undivided one-fourth interest in certain oil producing land in Louisiana, a one-eighth interest being inherited from his father and a one-eighth interest being acquired by donation from his mother. During

the taxable years in question the taxpayer received certain royalties and overriding royalties on account of his interest in the property. (R. 76.)

Treating these royalties as income belonging to the community, the taxpayer reported in his income tax returns only one-half of the amounts which were received. The Commissioner determined deficiencies in income taxes for the years 1937 through 1940 on the ground that the royalties were the separate property of the taxpayer and should have been included in their entirety in his taxable income. The taxpayer paid the deficiencies and, claims for refund having been filed with and rejected by the Commissioner, instituted suit to recover the taxes which were allegedly overpaid. (R. 77.) The District Court concluded that the royalties constituted income belonging to the community, only one-half of which was required to be included in the taxpayer's taxable income, and ordered that the taxpayer recover the amount of taxes which had been overpaid. (R. 75–83.)

The Circuit Court of Appeals reversed, holding that Louisiana law did regard oil royalties derived from the separate property of the husband as being his separate property and, accordingly, ruled that they are taxable in their entirety to him under the federal taxing statutes. (R. 86–95.)

ARGUMENT

The only issue before the Circuit Court of Appeals involved an interpretation of Louisiana law, namely, whether oil royalties received by the taxpayer from his separately owned property constituted income belonging to him or belonging to the community of acquets and gains existing between him and his wife. After a full examination and analysis of the Louisiana authorities, the court below concluded that, under the law of that State, such oil royalties remain the separate property of the husband when derived from his separately owned property. Since there is no clear demonstration that the law of Louisiana was misinterpreted (Pet. 7–10; Br. 2–5), the decision below should not be disturbed (*Helvering* v. *Stuart,* 317 U. S. 154); no adequate basis for the granting of the petition has been asserted with respect to this issue.

To the extent that the petition for a writ of certiorari (Pet. 4–10; Br. 4–22) has been framed on the assumption that there is a fundamental conflict between the decision below and the cases which uniformly hold that oil royalties are taxable as ordinary income rather than as proceeds from the sale of a capital asset (*Burnet* v. *Harmel,* 287 U. S. 103), the contention is without foundation. While the federal taxing statute, in some instances, looks to local law to determine the owner of the income to whom it is to be taxed

(*Poe* v. *Seaborn,* 282 U. S. 101; *Bender* v. *Pfaff,* 282 U. S. 127), the character of the income as being capital gain or ordinary income is a matter to be resolved solely under the criteria of the federal taxing statute which was intended to have a uniform application throughout the country (*Burnet* v. *Harmel, supra;* cf. *Palmer* v. *Bender,* 287 U. S. 551). For purposes of its community property law or for every other purpose, Louisiana is free to regard the receipt of oil royalties as being the proceeds from the sale of oil. This determines the ownership of the royalties as being the separate property of the husband or wife, and may indicate the person to whom they are taxable under the federal taxing statute; it does not have any effect on defining the character of the royalties as constituting ordinary income or capital gain for federal tax purposes. Similarly, the fact that oil royalties are taxed as ordinary income under the federal taxing statute cannot, contrary to the taxpayer's underlying assumptions (Pet. 4–10; Br. 4–22), require the State of Louisiana to regard them in a similar manner so as to make them fall into the community, nor change the law of that State which views them as proceeds from the sale of property and as belonging to the spouse from whose property they are derived. The rulings of the court below are completely harmonious on this point. *Commissioner* v. *Gray,* 159 F. 2d 834; *Commissioner* v. *Wilson,* 76 F. 2d

766; *Turbeville* v. *Commissioner,* 84 F. 2d 307, certiorari denied, 299 U. S. 581. There is no conflict with the decisions of this Court or of any other Circuit Court of Appeals.

CONCLUSION

The only question that emerges in this case is one of local law which was decided correctly by the court below. There is no conflict in decisions, and no question regarding the proper interpretation of the taxing statute is raised which has not already been decided by this Court. For these reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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APRIL 1948.

APPENDIX

Internal Revenue Code

Sec. 22. Gross income.

(a) *General definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * * [26 U. S. C. 1940 ed., Sec. 22.]

The provisions of Section 22 (a) of the Revenue Acts of 1936, c. 690, 49 Stat. 1648, and 1938, c. 289, 52 Stat. 447, are identical with the quoted provisions of Section 22 (a) of the Internal Revenue Code.

Louisiana Civil Code (Dart, Second Ed.)

VOL. 1

Art. 533. *Usufruct defined.*—Usufruct is the right of enjoying a thing, the property of which is vested in another, and to draw from the same all the profit, utility and advantages which it may produce, provided it be without altering the substance of the thing.

The obligation of not altering the substance of the thing takes place only in the case of perfect usufruct.

Art. 544. ***Fruits—Ownership.***—All kinds of fruits, natural, cultivated or civil, produced, during the existence of the usufruct, by the things subject to it, belong to the usufructuary.

Art. 545. *Kinds of fruits defined.*—Natural fruits are such as are the spontaneous product of the earth; the product and increase of cattle are likewise natural fruits.

The fruits, which result from industry bestowed on a piece of ground, are those which are obtained by cultivation.

Civil fruits are rents of real property, the interest of money, and annuities.

All other kinds of revenue or income derived from property by the operation of the law or private agreement, are civil fruits.

Art. 546. *Natural or cultivated fruits—Ownership.*—The natural fruits, or such as are the product of industry, hanging by branches or by roots at the time when the usufruct is open, belong to the usufructuary.

Fruits in the same state, at the moment when the usufruct is at an end, belong to the owner, without being obliged to compensate the other, for either work or seeds.

Art. 547. *Civil fruits—Ownership.*—Rents and income of property, interest of money, and annuities, and other civil fruits, are supposed to be obtained day by day, and they belong to the usufructuary, in proportion to the duration of his usufruct, and are due to him, though they may not be collected at the expiration of his usufruct.

VOL. 2

Art. 2334. ***Separate and common property of spouses.***—The property of married persons is divided into separate and common property.

Separate property is that which either party brings into the marriage, or acquires during the marriage with separate funds, or by inheritance, or by donation made to him or her particularly.

The earnings of the wife when living separate and apart from her husband although not separated by judgment of court, her earnings when carrying on a business, trade, occupation or industry separate from her husband, actions for damages resulting from offenses and quasi offenses and the property purchased with all funds thus derived, are her separate property.

Actions for damages resulting from offenses and quasi offenses suffered by the husband, living separate and apart from his wife, by reason of fault on her part, sufficient for separation or divorce shall be his separate property.

Common property is that which is acquired by the husband and wife during marriage, in any manner different from that above declared. But when the title to community property stands in the name of the wife, it can not be mortgaged or sold by the husband without her written authority or consent.

Art. 2386. *Fruits of paraphernal property—Ownership—Reservation by wife.*—When the paraphernal property is administered by the husband, or by him and the wife indifferently, the fruits of this property, whether natural, civil,

or the result of labor, belong to the conjugal partnership, if there exists a community of gains. If there do not, each party enjoys, as he chooses, that which comes to his hands; but the fruits and revenues which are existing at the dissolution of the marriage, belong to the owner of the thing which produce them. [As amended, Acts 1871, No. 87.]

ART. 2399. *Community of acquets and gains—Stipulation against required.*—Every marriage contracted in this State, superinduces of right partnership or community of acquets or gains, if there be no stipulation to the contrary.

ART. 2402. *Property forming community—Personal injuries to wife.*—This partnership or community consists of the profits of all the effects of which the husband has the administration and enjoyment, either of right or in fact, of the produce of the reciprocal industry and labor of both husband and wife, and of the estate which they may acquire during the marriage, either by donations made jointly to them both, or by purchase, or in any other similar way, even although the purchase be only in the name of one of the two and not of both, because in that case the period of time when the purchase is made is alone attended to, and not the person who made the purchase. But damages resulting from personal injuries to the wife shall not form part of this community,

but shall always be and remain the separate property of the wife and recoverable by herself alone; "provided where the injuries sustained by the wife result in her death, the right to recover damages shall be as now provided for by existing laws."

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